

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

APPLICATION OF EAST KENTUCKY POWER)
COOPERATIVE, INC. TO ADJUST) CASE NO. 94-336
ELECTRIC RATES)

O R D E R

On September 1, 1995, the Commission granted a rehearing of its July 25, 1995 Order requiring East Kentucky Power Cooperative, Inc. ("East Kentucky") to reduce its rates by \$33,493,930, a decrease of \$5,488,567 more than it had requested. The rehearing was limited to one of the issues raised by the Attorney General, by and through his Public Service Litigation Branch ("AG"), in his petition for rehearing - the interest income adjustment. A procedural schedule was established providing for discovery and an opportunity to request a hearing and file briefs. The parties agreed to waive a hearing and the case was submitted for a decision on the evidence of record and briefs.

Interest income is the interest earned by East Kentucky on its numerous long-term and short-term investments. The interest income adjustment involves determining the appropriate investment balances and rate of interest and calculating a reasonable amount of interest income for the test year. Interest income is an offset to revenue requirements and, thus, reduces the rates otherwise needed.

POSITIONS

The AG limited his analysis to the short-term investments and the appropriate interest rate to be applied thereto. The AG recommended that the short-term investment balances and interest rates as of December 31, 1994 be used in determining the appropriate level of interest income.¹ In addition, the AG recommended that the short-term investment balances be increased to recognize long-term loan funds East Kentucky would receive due to its construction of three combustion turbines ("CTs").² The AG claimed East Kentucky would reap a windfall from ratepayers if some amount of CT loan funds were not included in the short-term investment balances. The AG argued that the adoption of these recommendations is consistent with other adjustments adopted by the Commission in the July 25, 1995 Order. The AG recommended that the interest income be increased by \$4,304,979 over the amount determined in the July 25, 1995 Order.

East Kentucky expressed agreement with the Commission's practice of updating interest rates for both interest expense and interest income. Noting that it had provided the interest rates in effect as of January 1, 1995, East Kentucky recommended the use of those rates.³

¹ AG Rehearing Brief, at 2.

² Id., at 3. The AG offered three alternative recommendations which incorporated long-term loan funds related to the CT construction. The AG's preferred alternative was based on his original adjustment shown in DeWard Direct Testimony, Schedule 20.

³ East Kentucky Rehearing Brief, at 2.

East Kentucky supported the use of test-year-end balances to calculate interest income, except for short-term investments and certain bond funds associated with its debt service reserve funds. For these accounts, it advocated the use of normalized balances which adjusted for (1) significant fluctuations experienced during the test year, (2) funds used for the restructuring of Federal Financing Bank ("FFB") debt on January 3, 1994, and (3) scheduled debt retirements and construction expenditures made during 1994 and 1995.⁴ East Kentucky stated that, if the Commission did not agree that the proposed normalized balances were proper, the test-year-end balance for short-term investments should be reduced by amounts associated with the January 3, 1994 FFB debt restructuring and the bond funds should be reduced to remove gains booked during the test year.⁵ Further, East Kentucky conceded the reasonableness of the AG's request to include the test-year-end balance of CT construction work in progress ("CWIP") in the short-term investments balance.⁶ If all of East Kentucky's adjustments were adopted, interest income would be increased by \$1,004,206 over the amount determined in the July 25, 1995 Order.

The Kentucky Industrial Utility Customers intervened in this case, but neither propounded rehearing data requests nor filed a rehearing brief.

⁴ Id., at 3 and 5.

⁵ Id.

⁶ Id., at 4.

ANALYSIS

In the July 25, 1995 Order, the Commission accepted a historic test period ending December 31, 1993 and post-test-year adjustments to include the CTs, facilities constructed to serve Gallatin Steel Company, and 12 other adjustments agreed to by East Kentucky and the AG. The Commission stated that it was "not abandoning traditional rate-making concepts associated with the historic test period, but is recognizing the unique circumstances in this case."⁷ One of the well-established rate-making concepts applied in this case is the matching principle, which requires that all revenues, expenses, rate base, and capital items reflect the same time period. Given the acceptance of a modified historic test period, the Commission has applied the matching principle as consistently as possible in reviewing the rehearing issue.

In varying degrees, both the AG's and East Kentucky's positions are inconsistent with the matching principle. The acceptance of a modified historic test period did not result in the updating of all rate case item balances to some date long after the test-year end. Consequently, the AG's proposal to update the short-term investment balances to December 31, 1994 is inappropriate. The adjustment to interest income originally proposed by the AG was rejected for violating the matching principle,⁸ and nothing presented on rehearing has persuaded the Commission to modify that decision. Based on the matching

⁷ July 25, 1995 Order, at 5.

⁸ Id., at 9.

principle, East Kentucky's proposal to recognize the impact of events occurring during 1994 and 1995 is also inappropriate. However, because the Commission accepted adjustments to East Kentucky's outstanding long-term debt to reflect the January 3, 1994 FFB restructuring and the additional debt associated with the CTs, it will be necessary under the matching principle to recognize corresponding adjustments to East Kentucky's short-term investment balances.

The AG's claim of a potential East Kentucky windfall is unfounded. The Commission's establishment, in the July 25, 1995 Order, of a temporary credit mechanism in the fuel adjustment clause will remove the impact of the CT debt from East Kentucky's current rates⁹ and preclude any windfall.

In addition to violating the matching principle, East Kentucky's current proposal for the short-term investment and bond fund balances is inconsistent with its prior testimony. East Kentucky previously testified that:

EKPC's [sic] believes only test year end balances on debt for interest expense computations, and test year end balances on investments for interest income computations should be permitted, along with advances on debt for the combustion turbines.¹⁰

East Kentucky now attempts to modify that position to permit the use of normalized balances.¹¹ The Commission finds East Kentucky's

⁹ September 1, 1995 Order, at 6 and 7.

¹⁰ Eames Rebuttal Testimony, filed March 28, 1995, at 3.

¹¹ Response to the AG's September 21, 1995 Data Request, Item 6.

prior position to still be correct and, therefore, these two account balances should not be normalized.

CONCLUSIONS

The Commission finds that the interest income adjustment as calculated in the July 25, 1995 Order should be modified. The reduction to the short-term investment balances for the non-recurring gain on the sale of investments was incorrect and should be reversed. With the exception of the short-term investments, all balances used to calculate the level of interest income should be as of the December 31, 1993 test-year end. For short-term investments, the test-year-end balance should be increased by the total CT CWIP balance as of test-year end,¹² and reduced by the January 3, 1994 FFB debt restructuring transactions.¹³ To be consistent with the adjustment to interest expense, the Commission also finds it appropriate to use the interest rates as of January 1, 1995 to compute the adjustment. As shown in Appendix C to this Order, the Commission has determined East Kentucky's interest income should be \$7,826,153, an increase of \$2,679,260 over the amount contained in the July 25, 1995 Order.

¹² Total CT CWIP includes generation and transmission substation and lines. See Application Exhibit Z, page 1 of 39.

¹³ The January 3, 1994 FFB debt restructuring transactions were: (1) the early debt payment, which was recognized in the July 25, 1995 Order; (2) the prepayment penalties related to the early debt payment; and (3) the repricing premiums paid by East Kentucky to refinance a portion of its outstanding FFB debt.

The effect of the interest income adjustment on East Kentucky's net income is as follows:¹⁴

	<u>Adjusted Test Period</u>	<u>Rehearing Adjustments</u>	<u>Revised Test Period</u>
Operating Revenues	\$354,233,226	\$ 0	\$354,233,226
Operating Expenses	<u>265,031,926</u>	<u>0</u>	<u>265,031,926</u>
Net Operating Income	89,201,300	0	89,201,300
Interest on Long-Term Debt	53,265,579	0	53,265,579
Other Income and (Deductions) - Net	<u>5,494,574</u>	<u>2,679,260</u>	<u>8,173,834</u>
NET INCOME	<u>\$ 41,430,295</u>	<u>\$ 2,679,260</u>	<u>\$ 44,109,555</u>

REVENUE REQUIREMENTS

The Commission approved a Times Interest Earned Ratio ("TIER") of 1.15X in calculating East Kentucky's revenue requirements. Recognizing the Commission's decision on the appropriate interest income, to achieve a 1.15X TIER East Kentucky must reduce its annual revenues by \$36,177,474,¹⁵ or \$2,683,544 more than the reduction prescribed by the July 25, 1995 Order. This reduction reflects the interest income decision and a corresponding reduction in the PSC Assessment of \$4,291.¹⁶ This reduction in revenue should produce net income of \$7,989,928, which should be sufficient to meet East Kentucky's operating needs and the requirements of servicing its long-term debt. This reduction in revenue will

¹⁴ Adjusted Test Period from July 25, 1995 Order, at 19.

¹⁵ Appendix B reflects the amount of reduction for each of the 18 distribution cooperatives served by East Kentucky.

¹⁶ Due to calculation and computer rounding, the PSC Assessment reduction is \$7 larger than the mathematical difference between the interest income increase and the additional reduction in revenues. The resulting net income is consequently increased by \$7.

result in an 8.01 percent rate of return on net investment rate base.

REVENUE ALLOCATION AND RATE DESIGN

East Kentucky recommended that a revenue decrease in the range of \$1 million be allocated fully to its Section E Rate Schedule and indicated a preference for applying the full amount of the decrease to its Section E off-peak energy rate. As an alternative, East Kentucky suggested applying the decrease to the Section E demand charge. The AG made no recommendation on either revenue allocation or rate design in the rehearing phase of this case.

The decrease will be allocated consistent with the allocation of the initial decrease granted by the Commission's July 25, 1995 Order. This means all rate schedules will receive decreases based on class revenue requirements, with the exception of Inland Container which warrants no further rate decrease based on the cost-of-service studies presented by both East Kentucky and the AG.

The decrease allocated to Sections B and C is reflected in a further reduction in their energy rates.¹⁷ For Section E, the decrease is allocated to on-peak and off-peak sales in the same proportions as previously approved. The full amount of the on-peak decrease is achieved through a reduced demand charge while the off-peak decrease is reflected in a reduction to the off-peak energy rate. This rate design and intra-class allocation best maintains

¹⁷ The energy rate for Section A, which presently serves no customers, will receive the same decrease as Sections B and C, consistent with the Commission's rate decision in the July 25, 1995 Order.

the balance of on-peak and off-peak sales' responsibility for fixed cost recovery established in the July 25, 1995 Order.

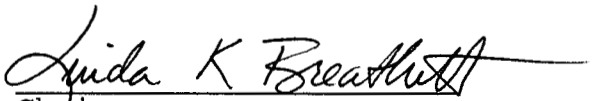
IT IS THEREFORE ORDERED that:

1. The rates in Appendix A are approved for service rendered by East Kentucky on and after March 1, 1996.

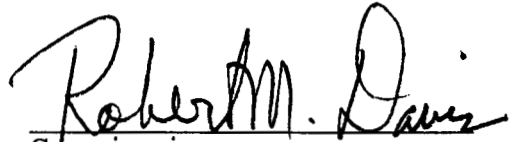
2. Within 20 days from the date of this Order, East Kentucky shall file with the Commission revised tariff sheets setting out the rates approved herein.

Done at Frankfort, Kentucky, this 28th day of February, 1996.

PUBLIC SERVICE COMMISSION


Chairman


Vice Chairman


Commissioner

ATTEST


Executive Director

APPENDIX A

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE COMMISSION IN CASE NO. 94-336 DATED FEBRUARY 28, 1996

The following rates and charges are prescribed for the member system cooperatives served by East Kentucky Power Cooperative, Inc. All other rates and charges not specifically mentioned herein shall remain the same as those in effect under authority of this Commission prior to the effective date of this Order.

WHOLESALE POWER RATE SCHEDULE

Section A

Monthly Rate

Energy Charge per KWH	\$0.019785
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Section B

Monthly Rate

Energy Charge per KWH	\$0.019785
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Section C

Monthly Rate

Energy Charge per KWH	\$0.019785
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Section E

Monthly Rate

Demand Charge per KW of Billing Demand	\$6.92
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Energy Charge per KWH:

Off-Peak	\$0.019578
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APPENDIX B

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE
COMMISSION IN CASE NO. 94-336 DATED FEBRUARY 28, 1996

East Kentucky Power Cooperative, Inc. has been granted a further rate reduction of \$2,683,544 herein which is in addition to the reduction of \$33,493,930 previously Ordered. The resulting total rate reduction is \$36,177,474. The total wholesale power reduction for each of the distribution cooperatives served by East Kentucky Power Cooperative, Inc. is set forth below.

<u>Cooperative Name</u>	<u>Amount</u>
Big Sandy R.E.C.C.	\$ 1,296,791
Blue Grass R.E.C.C.	2,309,091
Clark R.E.C.C.	1,660,316
Cumberland Valley R.E.C.C.	2,618,687
Farmers R.E.C.C.	1,647,363
Fleming-Mason R.E.C.C.	3,022,725
Fox Creek R.E.C.C.	726,253
Grayson R.E.C.C.	1,006,239
Harrison County R.E.C.C.	925,161
Inter-County R.E.C.C.	1,318,868
Jackson County R.E.C.C.	3,495,784
Licking Valley R.E.C.C.	1,131,751
Nolin R.E.C.C.	2,492,482
Owen Electric Cooperative	2,954,899
Salt River Electric Cooperative	2,965,123
Shelby R.E.C.C.	1,289,335
South Kentucky R.E.C.C.	3,618,828
Taylor County R.E.C.C.	<u>1,697,936</u>
Total - All Cooperatives *	\$36,177,632

* Difference in total due to rounding in
the calculation of East Kentucky's rates

APPENDIX C

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE COMMISSION
IN CASE NO. 94-336 DATED 2/28/96

EAST KENTUCKY POWER COOPERATIVE, INC. - CALCULATION OF NORMALIZED INTEREST INCOME

CATEGORY OF INVESTMENT	ACTUAL BALANCES	INTEREST RATES	NORMALIZED INTEREST INCOME
Cooperative Deferred Power Bill Plan	13,934,816	6.2000%	863,959
Money Market Funds w/ Investment Managers:			
PNC Balance	15,645	5.3820%	842
NCB Balance	38,808	5.3820%	2,089
WFS Balance	64,136	5.3820%	3,452
Long-Term Invest. Including Invest. Managers	8,785,086	6.4220%	564,178
Short-Term Investments			
Test Year End Balance	132,100,919		
Add: CT CWIP @ TYE (Gener. & Trans.)	7,110,450		
Less: FFB Early Debt Payment	(72,242,827)		
FFB Refinancing Premiums	(2,827,278)		
FFB Refinancing Penalties	(7,631,274)		
Net Short-Term Investments	56,509,990	5.2900%	2,989,378
Debt Service Reserve Funds:			
Dale Debt Service	641,700	5.7500%	36,898
Spurlock Debt Service Reserve	12,717,000	5.7500%	731,228
Smith Debt Service Reserve	5,368,500	5.7500%	308,689
Cooper Debt Service Reserve	1,061,923	5.3750%	57,078
CFC Capital Term Certificates:			
General Funds	6,998,144	5.0000%	349,907
Charleston Bottoms	657,500	3.0000%	19,725
Dale Pollution	278,750	3.0000%	8,363
CFC Subordinate Term Certificates:			
Spurlock	7,065,000	11.6480%	822,931
Smith	2,982,500	11.6480%	347,402
Cooper	590,000	6.5880%	38,869
Bonds Funds:			
Dale Bonds	1,267,028	4.9500%	62,718
Spurlock Bonds	6,402,882	5.6500%	361,763
Smith Bonds	3,210,687	5.4473%	174,896
Cooper Bonds	862,484	5.8954%	50,847
Cooperative Marketing Loans	596,161	5.1900%	30,941
TOTALS	130,048,740		7,826,153
TEST YEAR ACTUAL INTEREST INCOME			12,452,595
REVISED ADJUSTMENT			(4,626,442)
ORIGINAL ADJUSTMENT			(7,305,702)
CORRECTION TO ORIGINAL ADJUSTMENT			2,679,260

NOTES:

Actual Balances are as of December 31, 1993, Test Year End, except as noted. See Response to Commission's September 1, 1995 Order, Item 1, page 3 of 4, for Test Year End amounts.

Interest Rates are as of January 1, 1995. See Response to Commission's September 1, 1995 Order, Item 1, page 3 of 4.

Short-Term Investment Adjustments -

- CT CWIP as of Test Year End, see Application Exhibit Z, page 1 of 39.
- FFB Early Debt Payment, see Application Exhibit A, Schedule 13, page 1 of 3.
- FFB Refinancing Premiums, see Response to AG's December 7, 1994 Data Request, Item 30.
- FFB Refinancing Penalties, see Response to AG's December 7, 1994 Data Request, Item 30.

Original Adjustment from Commission's July 25, 1995 Order, page 10.